

# *The Influence of Inflation on the Consumption of Chinese Residents*

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**Abstract:** China's inflation rate fluctuation is higher than that of developed countries in the same period, while the world has achieved remarkable economic development. With the economic growth and the increase of income, the problem of income inequality in China has become increasingly prominent. The polarization between rich and poor will affect social stability and become a huge resistance to building a well-off society in an all-round way. Exploring the relationship between inflation and income inequality, and proposing targeted measures to reduce the income gap, is of great practical significance for China to deepen reform and enhance people's sense of happiness and gain. China's economy has also been affected by imported inflation in the context of the global epidemic. This paper will analyze the basic theory of inflation and related effects, and focus on its impact on China's macroeconomic consequences. This paper uses the swot analysis method to analyze the current inflation test in China from the negative and positive effects, threats and opportunities, and interpret the relevant policies of China at the current stage and make a reasonable forecast of the future inflation trend.

**Keywords:** inflation, interest rate, monetary policy

## 1. Introduction

China's inflation rate fluctuation is higher than that of developed countries in the same period. With economic growth and the increase in income, the problem of income inequality in China has become increasingly prominent. The polarization between rich and poor will affect social stability and become a huge resistance to building a well-off society in an all-round way. Exploring the relationship between inflation and income inequality, and proposing targeted measures to reduce the income gap, is of great practical significance for China to deepen reform and enhance people's sense of happiness and gain. In theory, inflation mainly affects income inequality through the income redistribution mechanism. Due to China's urban-rural dual development, unbalanced and inadequate economic and financial development and other current situations, different groups have different constraints, leading to different income groups' ability to cope with inflation, and different groups' responses to different types of inflation shocks are inconsistent, which also makes the effects of inflation redistribution vary from group to group and region to region, and there are long-term and short-term effects. The empirical results show that: first of all, whether the overall inflation, food inflation or

non-food inflation has significantly increased the income inequality between urban and rural residents, between urban residents and among rural residents; Secondly, both financial efficiency and financial depth have significantly reduced the income inequality between urban and rural residents, but there are differences in the impact between urban residents and rural residents. The development of financial depth is conducive to weakening the income inequality effect between urban and rural residents and between urban and town residents caused by inflation, while the improvement of financial efficiency has strengthened the income inequality effect between urban and rural residents and between urban residents caused by inflation. The effect of income inequality among rural residents. Finally, economic development is conducive to reducing income inequality. Urbanization, government expenditure, and education variables also have a significant impact on income inequality. Based on the results of theoretical research and empirical analysis, combined with the specific situation of China's development, the paper puts forward relevant policy recommendations on how to maintain price stability, reduce the income gap and improve the quality of financial development.

Inflation means that the growth rate of money quantity is higher than that of physical quantity in an economy for a period of time, and the general price level rises, so the purchasing power of unit currency decreases. Inflation plays an important role in China and the global economy. At this stage, the impact of inflation on the development of the country is studied by studying the changes in the national economy and the quality of life of residents in the context of inflation. This paper uses the generalized GMM estimation method to empirically study the impact of overall inflation, food inflation and non food inflation on income inequality between urban and rural residents, urban residents and rural residents respectively, and adds financial development variables to explore the role of financial development in the impact of inflation on income inequality. In the case of inflation, this paper uses SWOT method to study the advantages and disadvantages of the economy and how to control inflation, and to discuss the advantages, disadvantages, opportunities and challenges of inflation to the national economy under the national inflation situation. The rest of this paper is arranged as follows: The second part is a literature review of inflation, the third chapter discusses the current situation of inflation in China, and the fourth chapter is the impact of inflation on the macroeconomy.

## **2. Literature Review**

### **2.1. Definition and Impact of Inflation**

When inflation occurs, it is often accompanied by rising prices and the cost of living. Based on the generalized noise information model, this paper constructs the reaction mechanism equation of residents' inflation expectations and uses the Gradient Boosting algorithm to select the model and estimate the coefficient, so as to identify the influencing factors of China's residents' inflation expectations and their contributions to the formation of expectations [2]. The results show that in the process of forming inflation expectations, residents have different choices in the context of price information learning. Facing the structural differentiation of the inflation rate in the consumption and non-consumption fields, residents only pay attention to the price information in the consumption field; Within the consumption field, both food and non-food inflation rates significantly affect residents' inflation expectations, and residents are more sensitive to non-food inflation rates. Information such as money supply, house price, and economic output also significantly affect the formation of residents' inflation expectations. This paper analyzes the transmission mechanism of RMB appreciation to inflation from three paths of the exchange rate, interest rate, and foreign exchange reserves. The appreciation of the RMB can thus bring changes in the interest rate and exchange rate, which finally shows by the prices of imports and exports. In this case, it can influence the general domestic price level. thus affecting inflation. The government should support the

economy through the policy of moderately reducing interest rates and reserve requirements, support small and medium-sized banks and enterprises with weak pressure resistance, and adhere to the transformation from export orientation to double circulation. At the same time, we should pay attention to the close cooperation between the exchange rate policy and the interest rate policy, maintain the stability of the RMB value, and thus drive the recovery of China's financial market [3]. Inflation shows obvious structural characteristics, with substantial fluctuations in asset prices and basic stability of general prices coexisting for a long time. Whether the change in asset price is the reason for the weakening of the relationship between money and price level, and what is the impact mechanism, is worth our analysis. In view of this, this paper first summarizes the previous literature research, on this basis, establishes the "money quantity model" including the asset market, and summarizes the three effects of asset prices on the relationship between money and inflation [4].

## 2.2. Effect of Inflation

The regime of Argentina changed frequently after World War II, and the development of the economy was lack of the support of stable political power and policy protection, causing high inflation. Corresponding control plans were conducted by the Argentina government to reduce inflation since the 1970s, yet most of them failed except for the long-term implementation in 1991. According to Esquivel et al.'s (1998) monetary crisis measurement indicators, a monetary crisis can be considered when the accumulated depreciation of the real exchange rate is greater than or equal to 15% for three consecutive months. As can be seen from the table below, the plans of all Argentine governments ended in currency crisis. In the 21st century, Argentina's economic development plan has experienced the swing of interventionism and liberalism, but it cannot escape the doom of inflation and currency crisis after all. It can be seen from Table 1 and Figure 1 that except for the low inflation rate during the currency board system (1991.4-2002.1), Argentina's inflation rate hovered at a high level in other years, and the currency crisis was embedded in high inflation, which reflects the coexistence of the currency crisis and high inflation [5].

## 2.3. Consequences

On the one hand, inflation has led to the uneven distribution of income in Argentina, a larger difference between rich people and poor people, and the lack of domestic consumption in stimulating economic development were caused by the decline of MPC, and the economy is more dependent on export trade. However, another consequence of inflation is that the cost of labor is relatively rising, the country loses the advantage of cheap labor, the price of export commodities is rising, and the competitiveness of the international market is declining. In addition, the uniqueness of Argentina's export commodities further increases the difficulty of export, and the perennial deficit of the current account, so the pulling effect of export trade on economic development is also weak. On the other hand, funds tend to be pulled away from the real economy by inflation. Development, transformation, and upgrading will be "talk on paper" once the

Table1: Inflation control project result data.

Project title	Execution time	Plan context	Average inflation rate per year(%)	PHP devaluation in crisis year (%)
Gelbard project	1973.5-1975.3	● Nationalism, Multiple Rate System	96.9	86.3

Table1: (continued).

Tablita project	1978.12-1981.4	<ul style="list-style-type: none"> <li>● Used crawling pegs</li> </ul>	126.5	58.3
Alemann project	1981.12-1982.7	<ul style="list-style-type: none"> <li>● Used Single exchange rate</li> </ul>	157.0	80.7
Austral project	1985.6-1987.9	<ul style="list-style-type: none"> <li>● Refine government budget, introduce new currency units</li> </ul>	275.8	56.0
Primavera project	1988.6-1989.4	<ul style="list-style-type: none"> <li>● Stabilizing exchange rate and price level</li> </ul>	1723.0	97.9
BB project	1989.9-1990.2	<ul style="list-style-type: none"> <li>● Stabilizing exchange rate</li> </ul>	2567.0	91.3
Exchange project	1991.4-2002.1	<ul style="list-style-type: none"> <li>● &lt;free exchange law&gt;, currency board system</li> </ul>	1.2	69.5
Kirchnerismo	2003.5-2015.12	<ul style="list-style-type: none"> <li>● Emphasize the leading role of the state in the economy</li> <li>● strengthen foreign capital control, stress debt control</li> </ul>	20.4	98.4
Macri rehabilitation project	2015.12-2019.8	<ul style="list-style-type: none"> <li>● Eliminate state intervention in the economy</li> <li>● integrate exchange rates and lift strict capital controls</li> </ul>	53.7	98.4

### 3. Real Economy Loses Financial Support

Argentina's high inflation rate makes its real economy unable to achieve effective transformation and development all the year round, leading to the fundamental loss of impetus for economic growth. Therefore, it has seriously restricted its economic growth through consumption, export and production, making it fall into the "middle-income trap" gradually and deeply [5]. Classical Theory on Inflation

#### 3.1. The Decline in Consumption Caused by Rising in Interest Rate

Inflation would cause a rise in nominal and real interest rates in the short run due to an increase in money demand caused by rising price level. this phenomenon can be analyzed using the money market model which indicates the relationships between the quantity of money and the real interest

rate. By a simple trade-off mechanism in which people preferred to save more rather than consume more, the consumption and fluidity of the market will decrease.

### **3.2. Redistribution of Wealth**

An unexpected Inflation also means a redistribution of wealth from creditors to debtors. As the general price level increases, though the nominal repayment of debt does not change, it means less relative to previous circumstances. Those who borrow money would be better off, and those who lend money would be worse off.

### **3.3. Consequences Brought by Physical Policies and Monetary Policies**

The government and central bank would generally use physical policies (such as raising taxes and decreasing government spending) and monetary policies (such as open market operations, increase discount rate, and increasing reserve rate) to control and stabilize price levels responding to inflations. Such policies would directly or indirectly affect the price level and interest rate, causing changes in public consumption.

## **4. Current Situation of Inflation in China**

### **4.1. Analysis of Inflation**

In July, affected by the rising prices of pork, fresh vegetables and other food and seasonal factors, CPI increased from a flat month on month basis, with a slight increase year-on-year. " According to the data of the National Bureau of Statistics. Statistics show that in July, food prices rose 6.3% year on year, 3.4 percentage points higher than last month. In food, the price of pork increased by 20.2% from a 6% drop last month; The prices of fresh fruits and vegetables rose 16.9% and 12.9% respectively; The prices of grain, poultry meat, eggs and edible vegetable oil rose between 3.4% and 7.4%. In July, non-food prices rose 1.9% year on year, 0.6 percentage points lower than the previous month. Among them, the prices of gasoline, diesel oil and LPG rose by 24.6%, 26.7% and 22.4%, respectively, and all the increases fell back [6]. In July, CPI turned from flat to 0.5% higher. Among them, food prices increased 3% from a 1.6% drop last month. It is estimated that in July, the core CPI excluding food and energy prices rose 0.8% year on year, 0.2 percentage points lower than the previous month. In July, affected by many factors, such as international and domestic factors, the price of industrial products declined as a whole, and the national industrial producer price index (PPI) fell from flat to low month on month, and the year-on-year growth continued to fall. PPI fell 1.3% month on month (MoM) from flat last month; The year-on-year increase was 4.2%, 1.9 percentage points lower than that of last month. Because China's rapidly increasing CPI index has led to more and more serious inflation in China, and it will directly affect the livelihood of residents in China. Therefore, it is necessary to attach great importance to various problems existing in China's inflation at the current stage, constantly analyze and study them, and ensure that by analyzing the causes of inflation at the current stage in China, more and more attention is paid to the extremely serious impact of inflation on the social economy. At the same time, through the continuous connection of the deficiencies in the government's regulation and control policies, we can ensure that we put forward suggestions to solve China's current livelihood difficulties and inflation [7].

### **4.2. Inflation Control Policy**

The reopening of the global economy after the interruption of the epidemic has encountered some supply shortages. Although it has been foreseen, the facts have proved that the supply shortage is more common than expected and last longer than expected. In a market economy at least partially

governed by the laws of supply and demand, shortages are reflected in prices. When we sum up individual price increases, we call them inflation, which is at a level not seen for many years. The government should carry out scientific macro control targeting on possible problems, supporting the resumption of enterprises by close cooperation between monetary policy and physical policy and maintaining the stable value of RMB. In this way, to drive the recovery of the entire national financial market. First of all, we should link the money supply with the inflation rate and national income to realize the active internalization of the money supply; Secondly, by comparing the actual economic operation state with the target state, the decision-making authority gives the income tracking coefficient and price tracking coefficient to effectively control the inflation rate and ensure the smooth growth of the national economy [9].

On August 10, the People's Bank of China issued the Report on the Implementation of China's Monetary Policy in the Second Quarter of 2022. As for the arrangement of monetary policy in the next stage, the report proposed that we should strengthen the implementation of prudent monetary policy, give full play to the dual functions of monetary policy tools in terms of volume and structure, take the initiative to respond, boost confidence, do a good job in cross cycle adjustment, and give consideration to short-term and long-term economic growth and price stability, internal balance and external balance, Adhere to the principle of "no flood", no over issuance of currency, and provide more powerful and high-quality support for the real economy. Maintain reasonable and sufficient liquidity and increase credit support to enterprises. As for the price trend, the Report believes that the price level will remain generally stable throughout the year, but we should be alert to structural inflationary pressures. In general, China's economic operation has gradually recovered, the relationship between supply and demand is basically stable, and monetary conditions are appropriate. Under the favorable conditions of stable grain production and increase in production and stable operation of the energy market, it is expected that the price increase will still operate within a reasonable range. The expected goal of an average CPI increases of about 3% for the whole year is expected to be achieved, and the PPI increase will continue to generally decline in the year.

## **5. The Relationship Between Inflation and Consumption in China Based on SWOT Analysis**

### **5.1. Positive Impact**

The positive influence of inflation includes raising public expectations toward economic outlook. Since the pandemic started, the economic downturn has been a serious problem through our worldwide. Yet inflation could be a short period of upward movement in business cycles. After stagnation, inflation could achieve the goal of increasing fluidity.

### **5.2. Negative Impact**

In a longer time scale, inflation could bring negative effects. Inflation would primarily affect the development of China's real economy, thus causing the wage paid to workers to become higher in multiple industries. The price of raw materials will rise as well, both increase in labor cost and raw material cause will increase the total production cost of firms. In this case, if the enterprise wants to develop for a long time, it must raise the price of goods. However, when commodity prices rise, the competitiveness of the products produced by these enterprises will also be reduced; On the other hand, if the commodity price is not increased, the enterprise's income will be reduced, even the possibility of loss.

Thus, China's exported-oriented economy would be affected by inflation. China's exports contain a lot of processed products that rely on labor industries, so many firms in China would reduce labor costs to become more competitive in the product market. The lower the labor costs is, the stronger

the competitiveness of their products. In the short run, the salary becomes relatively lower than before because the price of goods increases, which means people cannot afford some goods in this period. So the level of consumption will decrease [10].

### 5.3. Possible Opportunities

There are many factors in which could eventually affect the price in foreign trade. The most significant influence is the fluctuation of exchange rate. Contradiction in demand could be made by the phenomenon when, for example, RMB increase in value yet depreciated internally. China's exchange rate changes and settlement mechanism would rapidly increase the money supply in the condition of trade surplus. When the prices continue to rise, it is reasonable and necessary to reduce inflation by using the method of increasing the exchange rate, and it will make the stimulated export trade pattern to become more reasonable for China. There is a risk of imported inflation in China. Imported inflation refers to that in an open economy because a country's economy is closely related to the international market, when there is inflation and price rise in the international market, such price rise will spread to the domestic market through the transmission path between the country and the international market, causing a widespread and continuous rise in the domestic price of the country.

### 5.4. Possible Threats

An increase in labor cost would be led by the occurrence of inflation and eventually cause the market price of products to rise. This will decline the firm's competitiveness in the corresponding market. Meanwhile, the loss of competitiveness for enterprises could also be caused by the depreciation of RMB in the domestic economy and the appreciation of RMB in the foreign economy. The prices of products would potentially increase through conversion calculation of the exchange rate. Imported inflation has many risks, which will lead to uneven income distribution and a growing gap between the rich and the poor. It will also lead to the destruction of the middle class [11].

Limitations of research and prospects for the future; swot was first put forward by Learned and others in 1965, which is widely proposed in the field of strategic management. However, this method has been in the past for a long time and has time limitations. In the future, we will adopt more analysis methods to draw more accurate conclusions. In addition, we will adopt data analysis methods and collect more data to make tables and graphs to demonstrate our conclusions.

## 6. Conclusion

In conclusion, we find that the effects of inflation can be positive and negative. In short term, inflation can help temporary recess cycle recover in economy. However, in long term, inflation has huge impacts on economic growth. As the cost of production increase, people's standard of living becomes worse because some people cannot buy same amount of goods than before.

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